Research on Money and Finance

Occasional Policy Papers

Cypriot banks:
A Pernicious Dependence on the Eurosystem

Costas Lapavitsas SOAS/RMF
Duncan Lindo LUBS/RMF

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1. Relying on the Eurosystem: A major problem for Cypriot banks

The Cypriot banking system is heavily reliant on liquidity supplied by the Central Bank of Cyprus (CBC) which is, in turn, reliant on Eurosystem of National Central Banks, including the ECB. In the course of the Eurozone crisis the ECB/Eurosystem has provided a channel for the banking systems of core countries to supply liquidity to the banking systems of peripheral countries, while minimising the risks for banks of the core. Cypriot reliance on the Eurosystem - ultimately on the banking systems of core countries - has afforded enormous political leverage to the troika of the IMF, the EU, and the ECB, as was seen in the events of March 2013.

However, since the second half of 2012 the provision of liquidity by the ECB/Eurosystem has declined, thus putting the CBC under pressure. The promise made by the ECB in 2012 ‘to do whatever it takes’ to rescue the Eurozone has had contradictory results. On the one hand, it has restored confidence in the banks of the core allowing them to reduce balances with their National Central Banks. On the other, it has been accompanied by a reduction in ECB/Eurosystem liquidity provided to the banks of the periphery and so has hindered the resumption of private bank lending.

In Cyprus, in particular, the banking system has remained heavily dependent upon on diminishing ECB/Eurosystem liquidity. The result has been constrained provision of liquidity by CBC to private banks, limiting the ability of the Cypriot banking system to generate credit and hence exacerbating recessionary pressures in the economy. The dependence of Cypriot banking on the Eurosystem has been a double-edged sword: private banking has (just about) continued to operate, but under heavy constraint. The ability of private banks to deliver their functions in the economy under these circumstances has been put in doubt. If Cyprus is to restore economic growth as well as assert its own interests – political, economic and social – it must find a way of breaking the dependence of its financial system on the Eurosystem of National Central Banks, and ultimately on the banking systems of the core countries of the Eurozone.

This paper investigates Cypriot bank dependency by examining the balance sheet of the Central Bank of Cyprus from Jan 2011 to Feb 2014. The results, summarily put, are:

On the asset side, lending by the Central Bank of Cyprus has:

i. Switched from normal monetary policy operations (MPO) to Emergency Liquidity Assistance (ELA) as Cyprus's credit rating has declined.
ii. *Decreased* in November 2012, thus preceding a general reduction in bank lending.
iii. Formed an increasing share of the total balance sheet of Cypriot banks as they have continued to deleverage, while being unable to find alternative sources of liquidity.

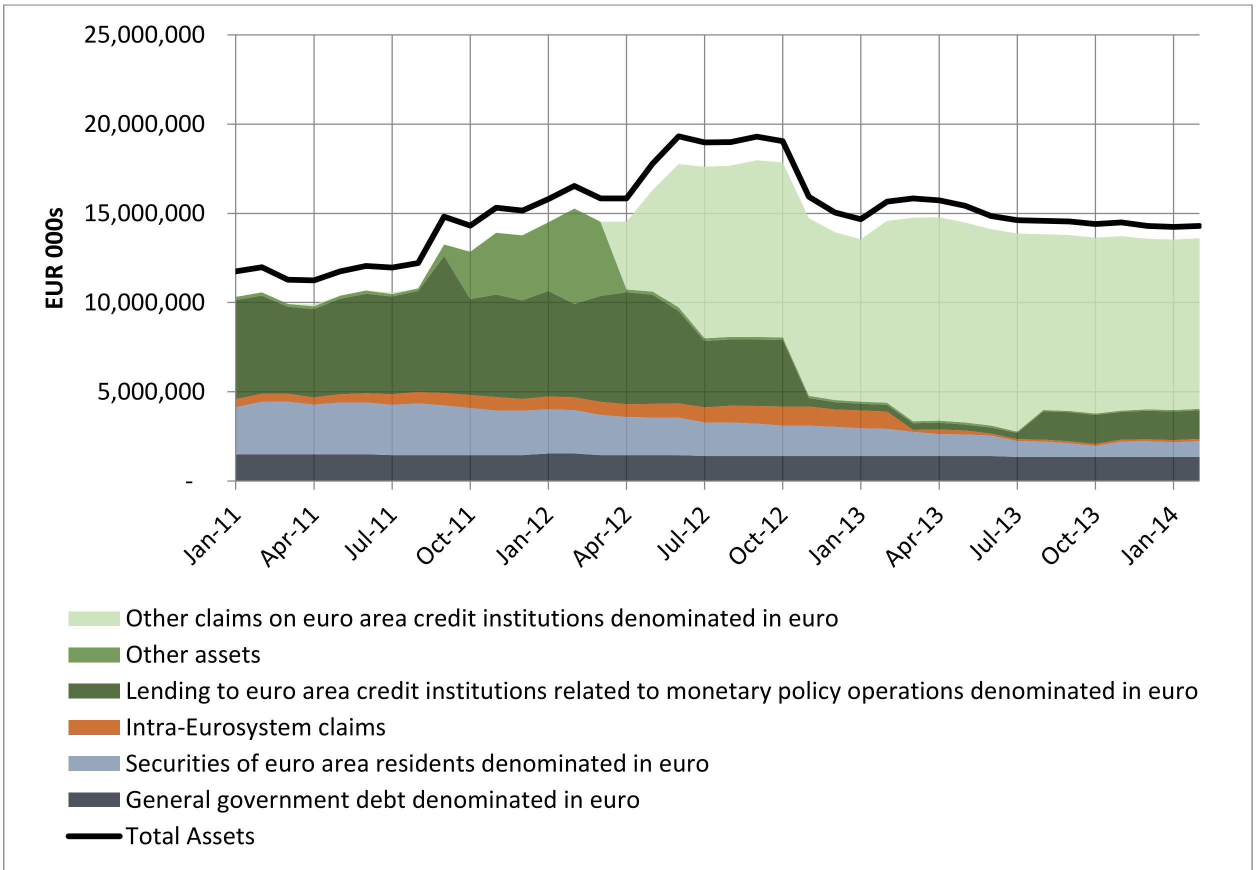
On the liability side:

i. Intra Eurosystem liabilities have remained critical to the funding of the Central Bank of Cyprus.
ii. Eurosystem funds were ultimately provided by the banking systems of the Eurozone's core, as shown by Target2 system balances.
iii. Target2 balances began to decrease in mid/late 2012 when the ECB introduced a raft of new policies presumably to calm financial markets. In Cyprus, ECB policy triggered the final phase of the Cypriot bank crisis and has contributed to constrained bank lending since then.

2. Central Bank Assets: Switch from normal monetary policy lending to ELA

Figure 1 shows selected assets from the Central Bank of Cyprus's balance sheet. From late 2011 CBC provision of liquidity switched heavily from normal monetary policy operations to ELA – labelled "Other claims on Euro area credit institutions…" in Eurosystem balance sheets and in figure 1.

Figure 1 Selected assets of the Central Bank of Cyprus, Jan 2011 – Feb2014, EUR 000s



Source: Central Bank Cyprus

The fall in normal policy lending by CBC to private banks was related to declining Cypriot creditworthiness in the eyes of the credit rating agencies, and thus to the ability of Cyprus to obtain ECB/Eurosystem liquidity – although the ECB has retained considerable discretion in this regard. Figure 2 uses sovereign debt rating as a proxy for the eligibility of

Cypriot banks' assets to serve as collateral at the ECB. It is clear that as Cyprus's sovereign debt rating declined, normal policy lending by the CBC to private banks also declined.

In particular in June 2012 Reuters reported that Fitch had become the last of the 4 eligible rating agencies to downgrade the Cypriot sovereign below investment grade rendering sovereign bonds ineligible for ECB MPO.[1] As expected, normal MPO by the CBC fell during that period but critically, and as figure 1 shows, the fall was more than replaced by an expansion of ELA. Note also that MPO lending by the CBC did not immediately fall to zero. Cypriot banks still had some eligible collateral; in early July the ECB expanded the criteria for non-marketable collateral eligibility and the CBC appears to have adopted the more relaxed criteria for "additional credit claims".

However, in November 2012, Fitch dropped its long term local currency rating to BB- (again later than the other two main agencies). At that point normal ECB funding to Cyprus dropped to negligible amounts presumably because, even with ECB discretion, Cypriot banks did not hold significant assets that could serve as eligible collateral. Unfortunately for Cyprus, the fall was not compensated for by an equivalent expansion of ELA and the central bank's balance sheet duly shrank. Normal lending picked up a little after the June 2013, but not enough to change the situation drastically and its rise was accompanied by a decline in ELA.[2] In short, the CBC reduced its aggregate lending – and thus its support for

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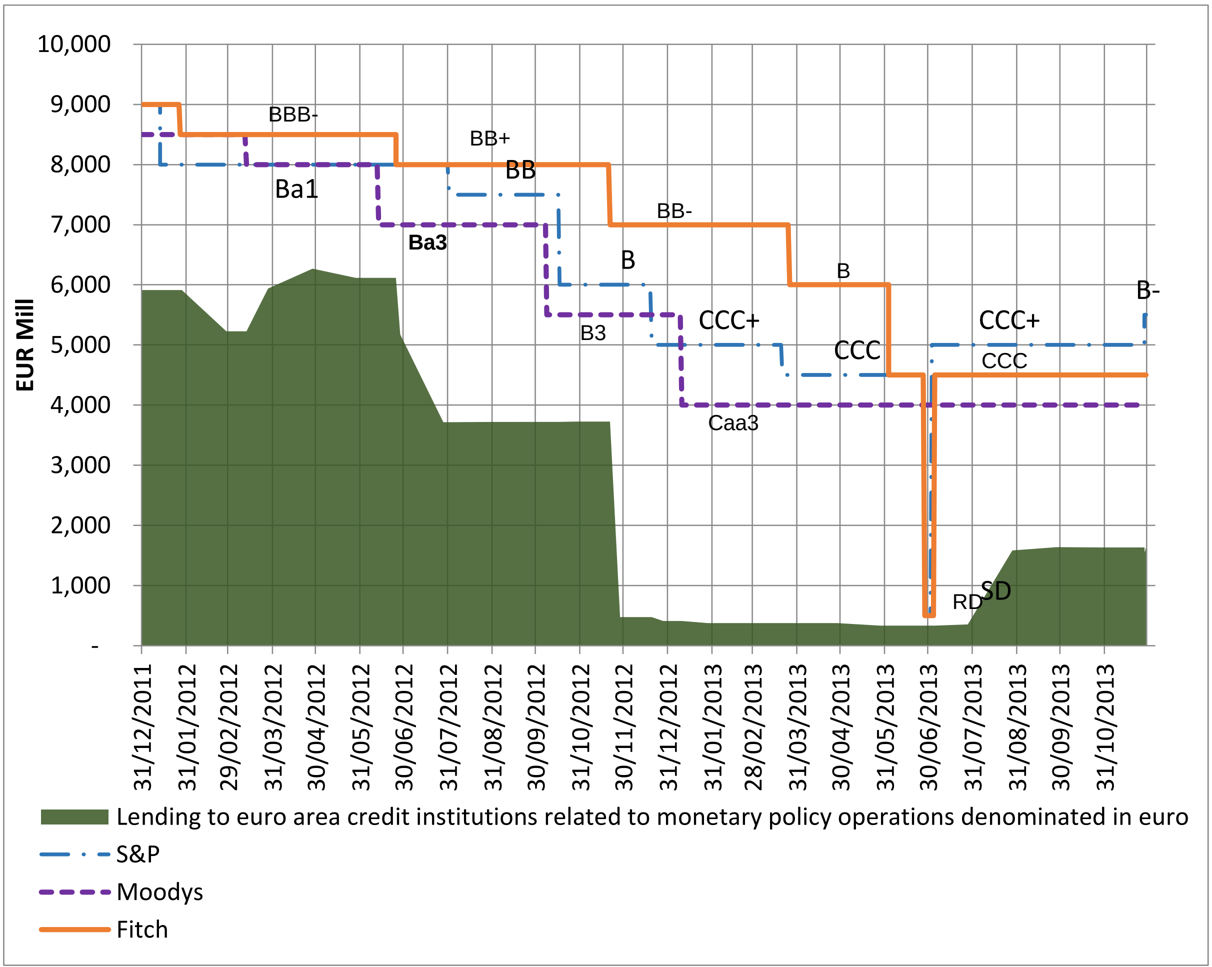
[1] http://www.reuters.com/article/2012/06/26/us-cyprus-ecb-idUSBRE85P13G20120626

[2] After the restructuring of some sovereign bonds in June 2013 Fitch and S&P briefly gave the Cypriot sovereign ratings of restricted and selected default, respectively. (http://www.reuters.com/article/2013/06/28/fitch-downgrades-cypruss-lc-idr-to-restr-idUSFit66218420130628) This was the nadir. It was followed by upgrades, and subsequently announcements from the ECB to the effect 'that marketable debt instruments issued or fully guaranteed by the

the Cypriot banking system – between November 2012 and January 2013; it then kept the volume of support fairly stable at a lower level from January 2013 to January 2014.

Figure 2 Central Bank of Cyprus normal montary policy operation lending to banks and Cyprus's sovereign rating, December 2011 – November 2013



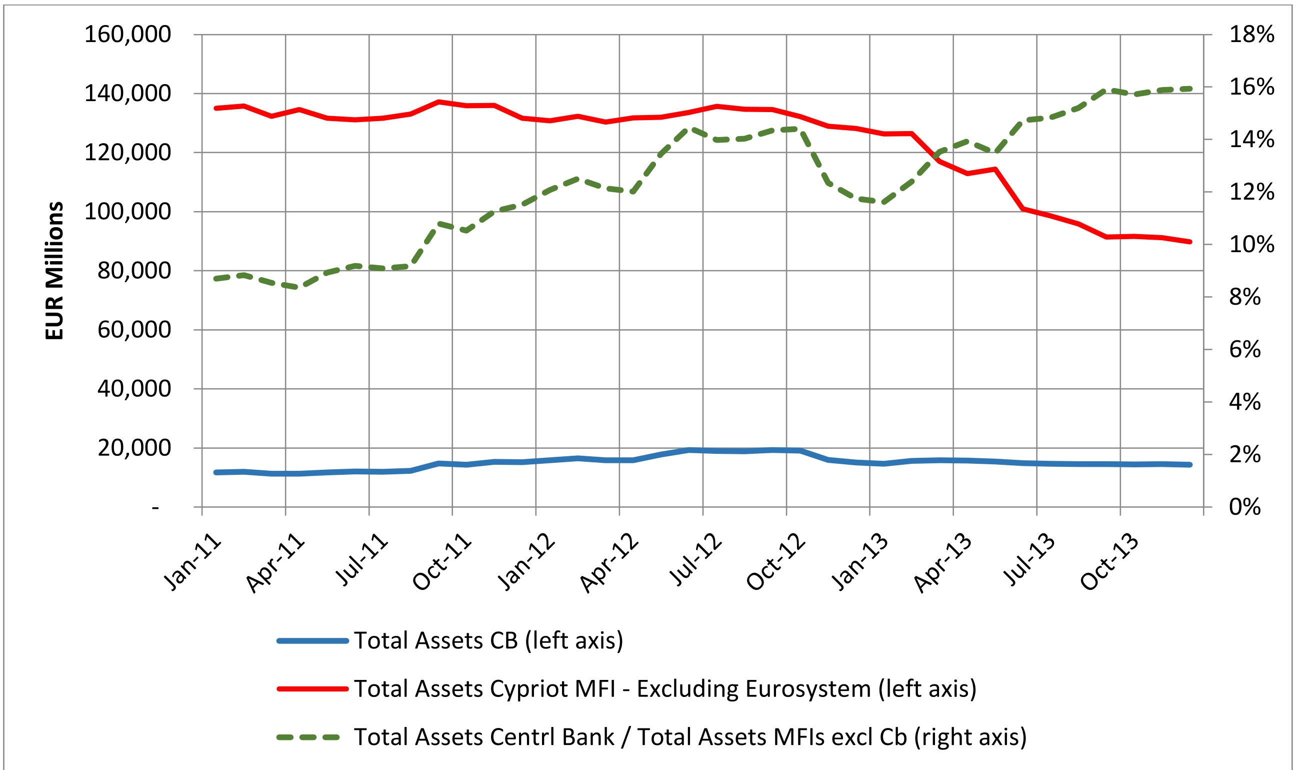
Source: Central Bank Cyprus and countryeconomy.com

The drop in total Central Bank lending to the banking system has not come about because the banks of Cyprus have returned to good health.

Figure 3 shows that first, central bank liquidity reduced, including as a share of banks' balance sheets; this was *followed* by the rapid shrinking of banks' balance sheet, i.e. *after*

Republic of Cyprus shall again constitute eligible collateral for the purpose of Eurosystem monetary policy operations' (http://www.ecb.europa.eu/press/pr/date/2013/html/pr130705.en.html) the CBC began to withdraw its liquidity.[3] As was shown in RMF Occasional Paper 3[4] the reduction in the balance sheet of the CBC came just before a sharp increase in the withdrawal of deposits by domestic agents, both firms and households. This withdrawal represented a steady loss of liquidity for Cypriot banks that was to culminate in the bank run and Troika intervention in 2013. More generally, Figure 3 also shows that the period since January 2013 has been marked by an inexorable *rise* in the dependency of Cypriot banks on reduced Central Bank liquidity.

Figure 3 Total Assets of Cypriot MFIs (excl. Eurosystem) and Central Bank of Cyprus



Source: Central Bank of Cyprus, ECB Statistical Data Warehouse, authors' own calculation

[3] Note that ECB/Eurosystem reports balance sheets for Monetary Financial Institutions, or MFIs, which essentially are banks.

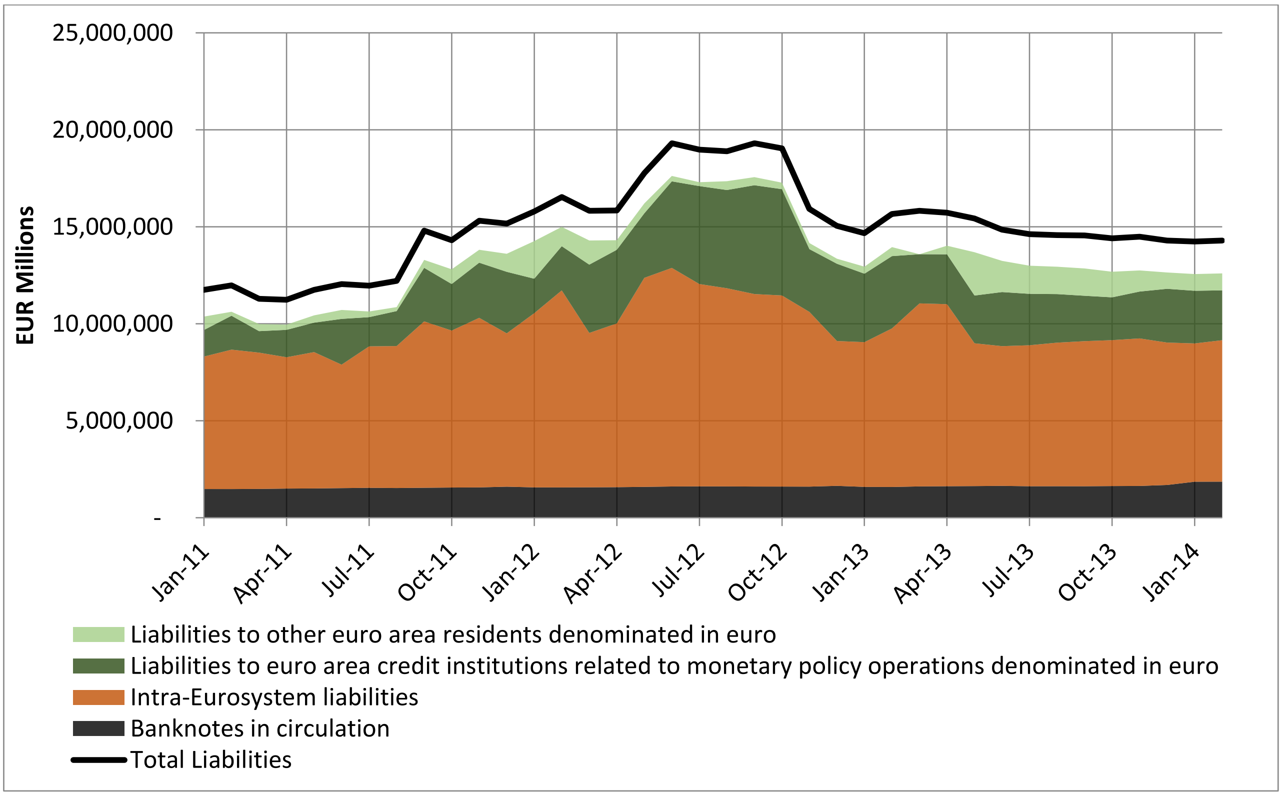
[4] RMF Occasional Policy Paper 3 – Cypriot banking system: at the point of no return, Duncan Lindo, Jan 2014, Available at: www.researchonmoneyandfinance.org/index.php/publication/occasional-policy-papers/92-cypriot-banking-system-at-the-point-of-no-return

The implications of increasing reliance by private banks on limited Central Bank liquidity will become clearer after examining the liabilities of the CBC.

3. Central Bank Liabilities

Turning to the other side of the Central Bank's balance sheet, Figure 4 shows that the funding of the Central Bank during this period has come principally from "Intra Eurosystem Liabilities", in other words from lending by other European central banks. It can be seen that the initial fall in normal MPO in June 2012 (discussed in the previous section) was accompanied by a smaller fall in intra-Eurosystem lending, and was absorbed by the Central Bank of Cyprus as domestic banks deposited their ELA proceeds at the central bank via the usual MPO instruments.

Figure 4 Selected Central Bank Liabilities

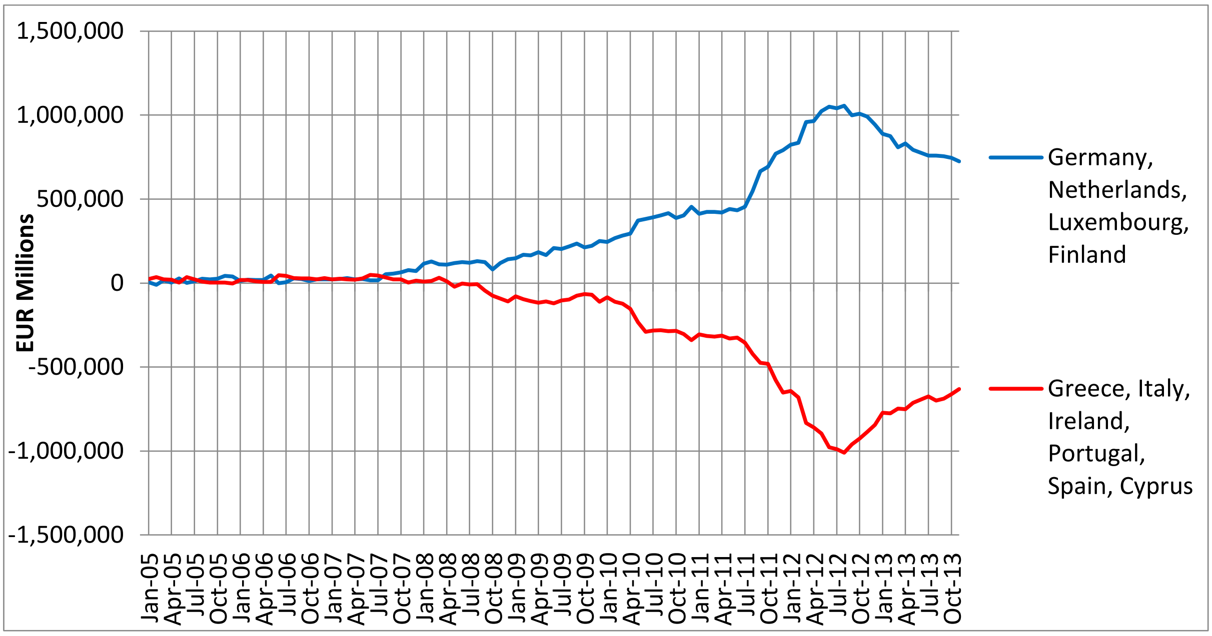


Source: Central Bank Cyprus

In November 2012, however, when the shrinkage of the CBC balance sheet began, there was a fall in intra-Eurosystem lending to the CBC, which was not accompanied by a compensating rise in domestic bank deposits at the Central Bank. Recall that ELA was not further expanded at this time, and thus domestic banks did not have additional funds. To get some clues as to why funding from the rest of the Eurosystem to the CBC was cut at this point it is instructive to consider the lending balances within the Eurosystem. These are expressed via the, now infamous, Target 2 payment system, which comprises the intra-Eurosystem lending and borrowing balances of the National Central Banks.

At the outset of the 2007-9 crisis confidence amongst banks began to evaporate and the interbank money market froze as banks preferred to deposit spare cash at their National Central Bank (NCB) rather than with other private banks. The result was that banks of the core (represented in Figure 5 by Germany, Netherlands, Luxembourg and Finland) deposited cash in the Eurosystem, while those of the periphery (represented by Cyprus, Greece, Ireland, Italy, Portugal, and Spain) borrowed from the Eurosystem (all via their respective NCBs). On these grounds, the funds for the “intra-Eurosystem” borrowing by the Central Bank of Cyprus – which have in turn provided critical liquidity to Cypriot private banks – were ultimately sourced from the banks of core Eurozone countries.

Figure 5 Selected Target2 balances, Jan 2005 - October 2013



Source: eurocrisismonitor.com

On 26th July 2012 Mario Draghi, the president of the ECB, announced: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." [5] This was accompanied by several policy changes, crucially including the possibility of outright purchases of goverment securities in secondary markets (OMT). These declarations by the ECB immediately acted to calm sovereign bond markets and financial markets in the Eurozone more generally. Figure 5 shows that this was exactly the moment at which banks of the core began to reduce cash balances at their own National Central Banks as confidence returned to the markets. Correspondingly the borrowings of peripheral countries began to fall.

The turnaround in the second half of 2012, following Draghi's announcement, has generally been seen as a great policy success as core banks have returned to the market.

[5] https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html

The expectation was that peripheral banks would also wean themselves off central bank liquidity. However, in the case of Cyprus, the reduction in provision of liquidity by the CBC – shown in Fig. 1 – which appears to have been driven by Draghi's announcement and thus by core banks withdrawing deposits from the Eurosystem – has maintained tight conditions for private banks. Indeed, it could be thought as a key moment in the events that triggered a bank run and led to intervention by the Troika in March 2013.

It is reasonable to expect that intra-Eurosystem balances will continue to decline for the foreseeable future, thus limiting the funding available to the Central Bank of Cyprus. At the same time, CBC liquidity will continue to play a vital role in the funding of Cyprus's private banking system. The only possible outcome of these tendencies is futher deleveraging by the Cypriot banking system. Contraction of private bank lending together with austerity measures imposed by the troika imply the continuation of strong recessionary tendencies. These are deeply problematic features of Cypriot finance at present. Unless Cyprus finds a way of reducing the dependence of CBC and hence of its private banks on the Eurosystem, it will continue to choke its chances of economic revival.